Internal Revenue Service

memorandum

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Br2:SJHankin

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to: District Counsel, St. Paul CC:STP
Attn: John C. Schmittdiel

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]
Tax Year ended: [redacted]

This memorandum is in response to your request for technical advice, dated May 18, 1987, and confirms oral advice rendered to your office on June 24, 1987.

ISSUES

Whether the Service should litigate either of the following issues against [redacted] and its [redacted], which are headquartered in [redacted] Texas, with appellate venue in the Fifth Circuit. 1/

(1) Whether an accrual-basis, subsidiary corporation which had previously accrued and deducted interest owed, but never paid, to its parent corporation should realize income when the parent corporation forgives the debt for the interest.

(2) Alternatively, whether the accrual-basis, parent corporation should recognize interest income when it forgives a debt for interest owed to it by its wholly-owned, subsidiary corporation, where the parent had not previously recognized such interest income.

CONCLUSION

The Service should not litigate either of the above issues against [redacted]. Accordingly, we recommend that no tax deficiencies attributable to either of the above issues be included in any notice of deficiency with respect to the [redacted] consolidated tax liability of [redacted].

1/ Although you have not sought technical advice with respect to the second issue, we believe that any evaluation of the instant case should consider both of the above issues.

FACTS

[redacted], a predecessor of this taxpayer, loaned various amounts to its subsidiaries: [redacted], [redacted], and [redacted] during the years [redacted] through [redacted]. [redacted] became the successor corporation of the other two subsidiaries. All of these corporations were accrual-basis corporations; however, during those tax years the parent corporation accrued interest income only when paid by the subsidiaries because of its doubt that the interest would ever be collected. The subsidiaries, on the other hand, accrued and deducted all interest expense as it became due on the loans.

In [redacted], [redacted], the successor corporation to the [redacted], forgave the interest indebtedness, "as a capital contribution to [redacted] in order to strengthen the capital structure of that subsidiary corporation to enhance its various business activities...." Board of Director's Resolution, dated [redacted]. [redacted] joined with its subsidiaries, including [redacted], in filing a consolidated income tax return for its [redacted] calendar tax year.

DISCUSSION

This case involves the situation where a shareholder (in this case a parent corporation) forgives interest indebtedness owed to its corporation (in this case a subsidiary corporation) under circumstances where the corporation had previously taken deductions for the interest it owed, while the shareholder-creditor had not included such accrued interest in income. The only tax year at issue is the year that the interest indebtedness was forgiven, i.e., the [redacted] tax year. 2/ The pertinent tax question is whether the debtor-corporation (the subsidiary in this case) or its creditor-shareholder (the parent corporation in this case) should recognize income as a result of the shareholder forgiving the interest owed to it by the corporation.

The 1980 Bankruptcy Tax Act resolved this issue prospectively by enacting section 108(e)(6) which in effect requires the corporation to recognize cancellation-of-indebtedness income upon the forgiveness of such interest debt by its shareholder.

2/ It is our understanding that almost all of the tax years for which the interest accrued are now closed years. Accordingly, we need not address the propriety of an accrual-basis subsidiary claiming interest deductions, while its accrual-basis parent corporation failed to report the interest as income because of its doubt that such interest would ever be collected.

Generally speaking, the effective date of section 108(e)(6) is December 31, 1980. That is, the specific provisions of the 1980 Bankruptcy Tax Act, relating to the tax treatment of discharge of indebtedness, are effective, in general, for transactions which occur after December 31, 1980. Section 7(a)(1) of the Bankruptcy Tax Act of 1980, Public Law 96-589, § 7(a)(i), 94 Stat. 3411 (1980). Since the forgiveness of interest indebtedness in this case occurred on [redacted], the instant case is governed by the law prior to the 1980 Bankruptcy Tax Act.

For cases arising prior to the effective date of the 1980 Bankruptcy Tax Act, the Service's primary position has been that a solvent, accrual-method corporation whose interest indebtedness to its shareholder had been forgiven realized gross income to the extent its deduction of such interest in previous years had resulted in a tax benefit. Rev. Rul. 73-432, 1973-2 C.B. 17. The Service has relied upon the tax benefit rule to support its contention that the cancellation of a previously-deducted liability for accrued interest gives rise to taxable income. Similarly, the Service has also argued that the forgiveness of the interest indebtedness was cancellation-of-indebtedness income pursuant to section 61(a)(12). In support thereof, the Service has argued that the forgiveness of the interest indebtedness is not a contribution to capital within the meaning of section 118 (which provides that contributions to the capital of a corporation are not income to that corporation). That is, the Service asserts that to the extent that the shareholder has never recognized the interest income as taxable it has no tax basis in the interest owed to it and therefore has nothing tax-wise to contribute to its corporation as a contribution to capital.

In support of the argument that forgiveness of the interest indebtedness is not a contribution to capital, the Service has relied upon Treas. Reg. § 1.61-12(a). Treas. Reg. § 1.61-12(a) states in material part:

> In general--The discharge of indebtedness in whole or in part may result in the realization of income *** In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt. (Emphasis added).

The Service has argued that the intention of the language, emphasized above, is to make clear that only the principal portion of the forgiven indebtedness will be considered a contribution to capital under section 118.

As a "fallback" argument, the Service has contended that the shareholder-creditor should be required to recognize interest income to the extent that it had not previously recognized such income. That is, if the forgiveness of the interest is held to be a contribution to the corporation's capital, then the shareholder should be deemed to have exercised dominion over the interest and to have thereby realized it as interest income. Corliss v. Bowers, 281 U.S. 376 (1930); Helvering v. Horst, 311 U.S. 112 (1940)

The Bankruptcy Tax Act of 1980 resolved the entire problem by adding section 108(e)(6). Section 108(e)(6) provides that:

> For purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital--
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> (A) section 118 shall not apply, but
>
> (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

Section 108(e)(6) thus provides that the discharge-of-indebtedness rules will apply to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt. Section 108(e)(6) accomplishes this by providing that section 118 does not prevent the recognition of discharge-of-indebtedness income by the corporation where a shareholder transfers nonbasis indebtedness to his corporation as a contribution to capital. 3/

In addition, section 108(e)(6) provides that where a debtor corporation acquires its indebtedness from a shareholder, as a contribution to capital, the corporation is treated as having satisfied such indebtedness to the extent of the shareholder's basis in that debt. The necessary implication of such debt satisfaction is that there can be no cancellation-of-indebtedness income to the corporation. 4/ Hence, the negative implication of section 108(e)(6) is that to the extent that a debt transferred to the corporation as a contribution to capital exceeds the shareholder's basis in that debt such nonbasis debt is to be treated as unsatisfied and is recognized as income by the corporation. To the extent that a debt for unpaid interest is

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3/ A shareholder has basis in the debt to the extent that the interest income has been previously reported as income.

4/ In addition, given that the debt was satisfied, the shareholder would not be entitled to a bad debt deduction with respect to any such basis he has in that debt.

considered to be unsatisfied, the shareholder-debtor will not realize interest income as a result of having transferred the debt to the corporation as a contribution to its capital. 5/

Both of the issues, previously stated, were considered by the Tax Court in the case of Putoma Corp. v. Commissioner, 66 T.C. 652 (1976), aff'd 601 F.2d 734 (5th Cir. 1979). In that case two individuals each owned fifty percent of the stock of two accrual-basis corporations. The two cash-basis individuals each cancelled the interest indebtedness owed to them by the corporations. Such indebtedness related to interest-bearing notes executed by the corporation in favor of the two individuals as part of the consideration for machinery previously sold to the corporations. The Tax Court in a reviewed opinion held that the cancellation of the interest indebtedness by the two individuals did not result in income to the petitioner corporations. The Tax Court based its holding on its conclusion that the forgiveness of the interest indebtedness was a contribution to capital, and thus concluded that the income exclusion rule of section 118 should override any otherwise appropriate application of either the tax benefit rule or the income inclusion rule with respect to cancellation of indebtedness.

With respect to the Service's alternative assignment-of-income argument, the Tax Court held that the two shareholder individuals did not recognize interest income from their cancellation of the interest indebtedness. In so holding the Tax Court expressly rejected the Service's assignment-of-income contention: that the cancellation of the indebtedness constituted the exercise of a power of disposal of income so as to warrant a recognition of the accrued interest as taxable income.

In response to the adverse Tax Court decision in Putoma, the Office of Chief Counsel recommended that the Commissioner file an appeal against the shareholders (under an assignment-of-income theory) as well as against the corporation (under a tax benefit approach). The Office of the Solicitor General authorized appeal against the corporation (under the tax benefit theory), but declined to authorize an appeal against the shareholders (under the assignment-of-income theory). Moreover, the Solicitor General's office expressed strong disagreement with that argument, per his memorandum dated May 10, 1977. Neither Chief Counsel nor the Tax Division of the Department of Justice protested the Solicitor General's decision not to appeal the shareholder case, i.e., the assignment-of-income issue.

5/ Accordingly, if section 108(e)(6) were applied to the instant suit, the discharged interest indebtedness would have been taxable to the subsidiary corporation since the parent would have had no basis in the debt, having never reported the interest as income in the years in which it would have accrued.

The appellate court concluded that the shareholder-individuals made a contribution to the capital of the corporations and that the tax benefit rule was thus not applicable thereto. Based on those conclusions, the appellate court held that the corporations were not required to include the cancelled interest in income in the year of its cancellation. See Putoma Corporation v. Commissioner, 601 F.2d 734 (5th Cir. 1979). The Service has since maintained that the Putoma case was wrongly decided. See Putoma Corporation, A.O.D., O.M. 70529 (July 7, 1980).

For the following reasons, we recommend that the Service not assert any tax deficiency arising from these two issues against [redacted].

1. In a reviewed opinion in the Putoma case, the Tax Court has decided both of these issues against the Service.

2. The instant case would have appellate jurisdiction in the Fifth Circuit. The Fifth Circuit in Putoma has already decided the corporation issue (the tax-benefit, cancellation-of-indebtedness issue) against the Service.

3. The Office of the Solicitor General in the Putoma case has previously refused to take the Service's appeal of the shareholder issue, i.e., the assignment-of-income issue. Moreover, neither our office nor the Tax Division of the Department of Justice protested the Solicitor General's decision not to appeal the shareholder case, i.e., the assignment-of-income issue.

4. The abusive tax results allowed by the Putoma case were reversed in 1980, on a prospective basis, by section 108(e)(6). Accordingly, these issues have no continuing importance for forgiveness of indebtedness income arising from transactions occurring after December 31, 1980.

Although we continue to disagree with the decisions of both the Tax Court and the Fifth Circuit in the Putoma case, we recommend that the Government not litigate a Putoma-type case against a taxpayer venued in the Fifth Circuit for the reasons cited above. 6/

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6/ Finally, it should be noted that the Service might have been able to disallow the interest deductions taken by the subsidiary corporations in prior years pursuant to section 267(a)(2), since the debtor and creditor corporations involved in this case were related parties pursuant to section 267(b)(3). In Putoma each of the shareholders owned fifty percent of the corporation's stock so that each shareholder and the corporation, did not constitute related parties as defined by section 267(b)(3).